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SUBJECT: THE SOCIETE GENERALE DEBACLE: SOME POSSIBLE IMPLICATIONS

¶1. (U) The release of Finance Minister Lagarde's report on Societe Generale's 4.9 billion euro loss by a "rogue" trader confirms details that we have heard from banking contacts and which have now been widely and well reported in the financial press. Insiders comment that "rogue traders happen" and compare the case with Barings or Sumitomo. More important, from our perspective, are the implications of the SocGen affair for French finance and business and its possible political impact. SocGen is one of only two major French true private-sector, publicly-traded international banks and it may not remain independent much longer. There is no question of a bank collapse -- SocGen is France's top retail bank and has more than adequate capital. However, its future in corporate and investment banking - its real profit center - is in doubt. The specter of this former crown jewel disappearing is a political hot potato and brings out the most interventionist instincts from all sides of the French political world, not least its President.

French Banking - a short history

¶2. (U) Large parts of France's banking sector were nationalized at the end of the Second World War, followed by further nationalizations in 1981. Francois Mitterrand later reversed his own disastrous nationalization policy and began to privatize state-owned enterprises. In 1987, SocGen was the first of several major bank privatizations. It was followed by the listing and sales of Credit Commercial de France, Suez and Paribas, with BNP following in 1993. A significant, mostly market-driven consolidation of the sector continued throughout the 1990's. Societe Generale acquired Credit du Nord in 1997. Credit Commercial de France bought Societe Marseillaise in 1998 and was in turn purchased by HSBC in 2000 in a friendly acquisition. BNP won a tough battle (with Credit Lyonnais) to buy Paribas in 1999, giving birth to France's largest bank and a major player in global banking.

¶3. (U) In parallel with the consolidation of private sector banking, France's two massive mutual banks expanded and reorganized as well, moving far beyond their traditional roles of credit unions and farm banks. Among the mutual banks, Credit Agricole acquired Indosuez in 1996 while Credit Mutuel purchased Credit Industriel et Commercial in 1998. In the savings bank sector, Banques Populaires bought stakes in the financial and investment banking entity Natexis (product of the 1996-1998 merger of state-owned Credit National and Banque Francaise du Commerce Exterieur) in 1998. Caisse d'Epargne acquired Credit Foncier privatized in 1999. Several years later, Banques Populaires and Caisse d'Epargne merged their financial and investment banking subsidiaries into their jointly owned Natixis subsidiary (independently one of Europe's top 25 banks, by capitalization).

¶4. (U) This period of turmoil and consolidation also saw the rise

and fall of Credit Lyonnais. One of France's top banks across the board in the late 1980's, Credit Lyonnais was kept out of the Mitterrand privatization program. However, the bank was undone in a sordid affair of massive lending to the US film industry and in particular for the failed takeover of MGM. Credit Lyonnais ended up owning the movie studio and eventually lost an estimated USD 5 billion in Hollywood. It also fell afoul of California insurance regulators in its (unrelated) acquisition of Executive Life and survived only by dint of a GOF bailout. The bank was privatized in 1999 and acquired by the mutual Credit Agricole in 2003 where it was later renamed LCL and reduced to a retail bank network.

The Banking Sector v.2008

¶5. (SBU) France's mutual banks today represent just under 30 percent of the banking sector (credit establishments) in terms of assets. These banks are, in some cases, listed and traded even while a controlling stake in the institutions is owned by the institutions themselves or, in theory, by their members and depositors. The former president of a major provincial bank which was acquired by Credit Mutuel described the mutual banks to us as independent fiefdoms with boards chosen by management and minimal accountability for performance to depositors, shareholders or the GOF, though they are, of course, regulated by the Commission Bancaire. Investment banking subsidiaries of mutual banks are listed companies but, again, overwhelmingly in the hands of the mutual banks (69 percent for Natixis; 95 percent for Calyon.)

¶6. (SBU) Until last month, BNP-Paribas and Societe Generale were the twin world class private sector, publicly traded international banks in France. (Mutual bank Credit Agricole ranks second in Fortune Global 500 for banks with a notional market capitalization of USD 77 billion, but it is largely self-owned and less of a player in corporate and investment banking.) Part of the motivation for GOF's aggressive privatization of the banking sector in the late 1980's

was the view that a dynamic financial sector was essential if France were to compete successfully with the UK and a newly united Germany. The development of Paris as a financial center became a key objective (the crowning moment of which was the 2007 merger of Euronext with the New York Stock Exchange.) While London and Frankfurt had significant leads in most areas of international finance, the French banks focused heavily from the outset on the emerging equities derivative business. One senior French banker asserted that Societe Generale was generally ranked as the top bank globally for equities derivatives trading while BNP-Paribas was generally among the top five.

So what happened?

7.(SBU) In short, the scandal appears remarkably similar to other "rogue" trader losses in recent years: a trader promoted from the ranks of the back office green eyeshades, engaging in what are supposed to be high volume low risk arbitrage trades, decides to open an uncovered position, which is hidden by exploiting the organization's internal control system. The trader builds an ever larger position which eventually is either exposed or collapses. The details of the Societe Generale loss have been widely reported and are estimated at 6.3 billion euro for 2008, offset by gains of 1.4 euro as of late December. One of our senior banking contacts previewed many of the details of SocGen's risk management failure which have since been confirmed in the Lagarde report and the press. SocGen ran a "permissive" trading operation in which oversight and risk management always took a back seat to trading. The trader in question never took vacation, refused to allow other traders to see his book, and was allowed to log frequent cancellations of trades (bogus hedge trades in this case.) It also seems clear that the bank ignored a series of warnings and red flags raised about the trader's activities from the Eurex exchange. In the week following the scandal, another senior French investment banker told us not to be hasty in judging SocGen management. Out of control traders can happen anywhere, he said, and result from the trader mentality. He cautioned that the damage to the bank could not be estimated until

the details of the risk management failure were known. Over the last few days, the trader in question and others appear to have confirmed that SocGen trading operated with extremely lax oversight. Proprietary trading profits appear to have been the overriding objective of the organization

¶8. (SBU) In terms of unwinding the open position, our contacts agree that while the market was highly unfavorable, SocGen had no choice but to liquidate the position quickly and in secret. According to our banking contacts, the fraud was discovered by the bank on Friday, January 18th. The bank had quantified its exposure by Sunday and informed Bank of France Governor Christian Noyer and the position was unwound over the next three days culminating with an announcement to the Bank's board on Wednesday and a public announcement the next day. The Elysee learned of the situation at about the same time as the Commission Bancaire and the bank's board.

What does it mean?

9.(SBU) It is unclear at this point whether Societe Generale will survive as an independent entity. Numerous breakup or takeover options have been mooted, prompting French officials to warn off foreign "predators." What is clear, is that the corporate and investment banking business of Societe Generale have suffered a severe and perhaps mortal blow and that the reputation of French finance is badly tarnished, especially in equities derivatives, the one area in which France has been a global leader. At the retail level our investment banking contact assured us, SocGen is one of seven major banking networks in France and its acquisition or merger would have little impact. Retail banking in France is a saturated and slim-margin business. Societe Generale's extensive investments in retail networks in central and eastern Europe should remain a valuable asset. At the corporate level, however, Societe Generale's disappearance (whether by pulling back from the corporate finance business or by merging into another group) could severely impact its traditional French corporate investment banking clients, in the midst of a global credit crunch and faced with the backdrop of a slowing global economy.

10.(SBU) The possibility of a SocGen takeover raises issues of French industrial policy beyond such a deal's impact on French corporate clients. Despite the EU Financial Services Directive, President Sarkozy and other senior GOF officials have made clear their strong opposition to a merger or takeover by a foreign "predator." The GOF has limited de jure means to block such a deal but a great deal of de facto power and we consider that the GOF's clear and strong interest in keeping SocGen "French" is consistent

with an emerging Sarkozy version of French industrial policy that is very much focused on supporting national champions or facilitating mergers and partnerships to create champions that are world leaders in their sectors. We plan to further examine how Sarkozy's approach differs from previous versions of France Inc. but it appears that maintaining adequate corporate banking support in French hands is important to this strategy.

¶11. (SBU) Trading scandals can and do occur anywhere and it would be wrong to pin blame for the Societe Generale debacle on French business practices writ-large. But as this story unfolds, the clubbiness of the upper reaches French business and government and the tolerant environment it engenders is likely to come in for further examination. Gerard Rameix, Secretary General of France's market watchdog, the AMF, was subordinate to then Finance Ministry Budget Director and current Societe Generale CEO, Daniel Bouton. Banque de France Governor Christian Noyer was chief of staff and subsequently an assistant secretary-equivalent at the Finance Ministry while AMF President Michel Prada was also a former budget director. All are "inspecteurs des finances," the most powerful of the French administration's grand corps of graduates from the Ecole Nationale d'Adminstration. None of this suggests wrongdoing -- Bouton, Noyer, Prada and Rameix are highly competent -- but it adds to the perception that the country's homogenous grooming of its elite contributes to myopia.

12.(SBU) Despite high-profile business scandals in recent years involving members of the corps - Credit Lyonnais and Vivendi come to mind - the inspecteurs des finances still dominate senior management of France's most established companies. And President Sarkozy, for all of his criticism of the country's traditional elitist governing structures, has shown little appetite for shaking up a system that produces CEOs attuned to balancing the interests of shareholders with those of the state. The president's public suggestion that Bouton resign ("accept his responsibilities") reflected views the Elysee had also passed directly to Societe Generale board members. But in the longer term we suspect that in sectors considered strategic - finance being one - the Sarkozy government is just as happy dealing with an old boys (and girls) club that knows how the game is played.

Stapleton